

## Closing **Views**

# Much ado about **dividends**



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Eliminating the double taxation of dividends is more notable for what it won't do than for what it will.

**In January, President George W. Bush** proposed eliminating the double taxation of stock dividends. Taxing dividends twice—at both the corporate and the individual level—has long differentiated the US tax system from those in many other countries, including Australia, France, and Germany. As the proposal moves through Congress, the debate is likely to focus on how much the change would stimulate the economy, if at all, and which sections of the US population would probably benefit most.

We won't comment on those broader macroeconomic and political issues, but we have watched with interest as business commentators studied the proposal from corporate perspectives. Some have turned to finance theory to analyze whether the proposal could raise the share prices of companies that pay dividends and change the policies of those that don't. Others suggest, even more sweepingly, that ending the double taxation of dividends might better align corporate strategies with economic fundamentals by improving the use of capital and restoring a greater degree of soundness to the formulation of strategy after a period when debt-financed growth and acquisitions seemed to claim pride of place in many executives' strategic thinking.

We doubt all this. The proposed tax cut, when viewed with an understanding of the shareholder makeup and share price movements of US companies, seems unlikely to have a significant or lasting effect on US share prices. Moreover, history and practice suggest that if the proposal becomes law, most US companies will not—and should not—change their dividend policies significantly.

## What the tax cut would do for shareholders . . .

For individual investors, the size of the proposed tax cut would depend on the extent to which income had already been taxed at the corporate level. Investors who received dividends from companies that had paid US income tax on all their earnings wouldn't pay additional taxes. If those companies paid tax on only part of their earnings, investors would get a corresponding tax reduction.

As long as taxes had been paid, investors would benefit from a tax reduction even if a company retained its earnings instead of distributing them as dividends. Under the proposal, when investors sold shares in such companies, the companies would be required to recalculate the stated purchase value of the shares to reflect undistributed earnings. Investors would then pay proportionately lower taxes on the narrower capital gains.

## . . . and what it would not do for them . . .

But the proposed tax cut isn't likely to have a major lasting effect on US share prices, primarily because the key investors who drive them are already exempt from taxes. What little impact the proposal may have was probably reflected in the 2.2 percent gain in the S&P 500 the day before it was announced.

Those who believe otherwise draw on classic finance theory.<sup>1</sup> In a world without taxes, theory suggests, shareholders would be indifferent to whether a corporation paid dividends, since the funds to do so would come at the shareholders' own expense. In a world with taxes, shareholders may face different tax rates on, for example, dividends as opposed to capital gains. They would care whether a company retained its earnings or distributed those earnings as dividends, because this would affect how much they got to keep. If all investors paid taxes on dividends, yes, share prices probably would rise if the tax were eliminated.

The fact, however, is that tax-paying US individual shareholders own a minority of all US shares—28 percent in 2002, whereas tax-exempt US institutions and individuals who hold shares in tax-exempt accounts owned 61 percent. (The remainder was in foreign hands.) For the most part, tax-paying individual shareholders don't drive share prices, whereas nontax-paying institutional investors do: the trading activity of a company's top 40 to 100 investors—again, usually big institutional investors—accounts for 70 percent of its stock price movement.<sup>2</sup> Since these investors are indifferent to the issue of taxes on their dividends, they are unlikely to set in motion the kinds of changes in their portfolios that would drive up share prices.

<sup>1</sup>See Merton H. Miller and Franco Modigliani, "Dividend policy, growth, and the valuation of shares," *Journal of Business*, Volume 34, Number 4 (October 1961), pp. 411–33.

<sup>2</sup>For S&P 500 companies with a market capitalization from \$500 million to \$200 billion. See Kevin P. Coyne and Jonathan W. Witter, "What makes your stock price go up and down," *The McKinsey Quarterly*, 2002 Number 2, pp. 28–39 ([www.mckinseyquarterly.com/links/4981](http://www.mckinseyquarterly.com/links/4981)).

### ... or for strategists

Similarly, if the proposed tax cut were enacted into law, most US companies probably wouldn't and shouldn't change their dividend policies significantly. The questions these companies consider would remain the same: Can they consistently and reliably pay a dividend at the proposed level every quarter? How would the markets interpret any changes in dividend policy? For many companies that wish to execute a one-off distribution, share repurchases would remain a more attractive option, as there is no implicit promise that the payout will be repeated every quarter.

Our observations of corporate behavior suggest that it is also unlikely that companies would pay dividends rather than make necessary capital investments. Companies that can find valuable projects typically are not constrained by sources of financing, whether equity or debt, or by commitments to pay dividends. Managerial limitations—finding the time and skills to bring promising projects to fruition—are a much greater hurdle.

Certain commentators have suggested that reducing the taxation of equity income would encourage companies to favor raising equity capital rather than debt, thus correcting a perceived swing toward debt financing in the 1990s. But with the exception of telecommunications companies and utilities at that time, US corporations have held their debt-to-capital ratios remarkably constant over the past 40 years, at an average of 45.5 percent. In fact, during much of the 1990s the level was lower than the average, so there is no swing toward debt financing to correct.

Still others have predicted that managers will have to introduce or increase dividends to meet investor demand. But we believe that the preponderance of tax-indifferent institutional investors will keep the demand for significant increases low. There will be some exceptional cases, such as companies that have accumulated large cash reserves (and are likely to come under pressure from shareholders to distribute them) as well as companies whose CFOs must optimize wealth for shareholders with significant stakes.

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In the end, the proposed tax cut will not have a significant impact on the wealth of investors or the behavior of managers. Both would be better off if they looked at the best underlying ways to create value rather than overly concerning themselves with the mechanics of how it is returned to shareholders. **Q**